

**MEMO# 10317**

September 23, 1998

# **SEC STAFF REPORT ON THE SOFT DOLLAR PRACTICES OF BROKER-DEALERS, INVESTMENT ADVISERS AND MUTUAL FUNDS**

\* The Report can be found on the SEC's Web site at [www.sec.gov/news/studies/softdolr.htm](http://www.sec.gov/news/studies/softdolr.htm). [10317] September 23, 1998 TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 28-98 COMPLIANCE ADVISORY COMMITTEE No. 29-98 INVESTMENT ADVISER ASSOCIATE MEMBERS No. 25-98 INVESTMENT ADVISER MEMBERS No. 26-98 SEC RULES MEMBERS No. 75-98 RE: SEC STAFF REPORT ON THE SOFT DOLLAR PRACTICES OF BROKER-DEALERS, INVESTMENT ADVISERS AND MUTUAL FUNDS

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The SEC's Office of Compliance Inspections and Examinations (OCIE) has issued a report entitled Inspection Report on the Soft Dollars Practices of Broker-Dealers, Investment Advisers and Mutual Funds (the "Report").\* The Report summarizes the findings from a series of sweep exams of soft-dollar practices of 75 broker-dealers and 280 investment advisers and mutual funds and contains the staff's recommendations from those findings. The parts of the Report dealing with investment advisers and investment companies are summarized below. A copy of the report is attached. Investment Adviser Examination Findings The Report includes the following general findings regarding investment advisers' use of soft dollars: ` Almost all investment advisers obtain products and services (both proprietary and third-party) other than pure execution from broker-dealers and use client commissions to pay for those products and services. Investment advisers and mutual funds that participate in soft-dollar arrangements vary in type and size. ` The vast majority of products and services received by advisers with soft dollars are within the safe harbor established by Section 28(e) of the Securities Exchange Act. ` Advisers that obtained non-research products and services failed to provide meaningful disclosure of such practices to their clients. Even with respect to products and services within the safe harbor, many advisers' disclosures of their soft dollars practices were inadequate, in that they did not provide sufficient information to enable a client or potential client to understand the adviser's soft dollar policies and practices. ` With respect to "mixed-use" items, many advisers either were not allocating the purchase price between hard and soft dollars or could not justify how the hard dollar/soft dollar allocation was reached. ` There is confusion regarding how various items used to send, receive and process research electronically should be classified (i.e., whether they are research or non-research). ` Despite existing guidance that research credits generated with principal transactions fall outside the Section 28(e) safe harbor, some advisers used principal transactions, such as OTC principal trades, to earn soft dollar credits without adequate disclosure. ` Most investment advisers lack comprehensive soft dollar

controls. Most of the large advisers that were examined did not have centralized management or control over the receipt of products and services for soft dollars. In addition, the staff found that many advisers did not maintain adequate documentation of soft dollar transactions, the products received, their uses and allocation decisions concerning mixed-use items. These two factors taken together made it difficult for advisers to adequately supervise and control their soft dollar activities, and to ensure that their disclosure to clients was appropriate.

**Investment Company Examination Findings**

The staff's review of mutual fund soft dollar practices focused on directors' review of funds' soft dollar usage and on the disclosure of soft dollar arrangements by funds and their advisers. The Report states that research and other services purchased by the adviser with the fund's brokerage commissions bear upon the reasonableness of the adviser's fee because the adviser otherwise would have to create the research and services itself or purchase them with its own money. Therefore, fund advisers that have soft dollar arrangements must provide their funds' boards with information regarding their soft dollar practices in connection with the board's review of the advisory contract under Section 15(c) of the Investment Company Act. The staff found that the extent of information provided by advisers to fund boards varies widely. The Report states that many advisers provide the board with their Form ADV, but that the Form ADV was not designed to fulfill a board's responsibilities under Section 15(c). Attached as Appendix G to the Report is a list compiled by the staff of information that some fund boards request and advisers provide. With respect to directed brokerage arrangements, the staff found that fewer than 15% of advisers to mutual funds had arrangements with broker-dealers to offset fund expenses such as audit, legal and custodial fees. The staff further found that about half of those funds did not "gross up" their expenses on financial statements, with accompanying explanation in the footnotes to disclose the effect of using fund commission payments to reduce certain fund expenses, as required pursuant to an SEC rule adopted 1995. The staff reasoned that the funds that did not "gross up" their expenses deemed the amounts to be immaterial in relation to the fund's other expenses. The Report states that, "While the rules do not indicate a materiality threshold, it appears that some funds are interpreting the rules to allow an exception in cases where per share NAV is not affected." The Report recommends that the Division of Investment Management provide clarification with respect to this issue. The Report states that step-out trades (i.e., an arrangement in which an adviser directs trades to a broker-dealer with the instruction that the broker-dealer execute the transaction and that another broker-dealer provide soft dollar products/services) have become an additional incentive used by fund advisers to reward broker-dealers for selling fund shares. The Report explains that advisers who seek to do business with broker-dealers that have sold fund shares must still fulfill their duty of best execution and must disclose that the practice is a factor considered by the adviser in selecting broker-dealers. The process of having an executing broker-dealer step out a portion of a trade in favor of another broker-dealer can reduce or eliminate this conflict for an adviser. The Report states that a conflict would exist if an adviser asks executing brokers to step out trades for its private clients to increase the compensation received by brokers that are involved in distribution activities of shares of funds sponsored by the adviser. The staff did not see this arrangement during their sweep exams, but will continue to look closely at this issue.

**Recommendations**

Based on the results of the sweep exams and its experience in examining soft dollar practices of investment advisers, the staff makes the following recommendations: ` The SEC should publish the Report to reiterate guidance with respect to the Section 28(e) safe harbor and to emphasize the obligations of broker-dealers, investment advisers and investment companies that participate in soft dollar arrangements. In addition, the SEC should reiterate and provide further guidance with respect to the scope of the safe harbor, particularly concerning (a) the use of electronically provided research and the various items used to

send, receive and process research electronically, and (b) the use of items that may facilitate trade execution. ` The SEC should adopt recordkeeping requirements that would provide greater accountability for soft dollar transactions and allocations. Specifically, rules should be adopted to require (a) broker-dealers to furnish to each investment adviser a statement of all products, services and research provided to the adviser in exchange for soft dollars, (b) advisers to keep these statements and, where advisers obtain soft dollar benefits from multiple brokers, to maintain their own detailed list of all products and services received for soft dollars, and (c) advisers to maintain a written record of the basis for allocations of mixed-use products and services between their hard and soft dollar components. ` The SEC should modify Form ADV to require more meaningful disclosure by advisers and more detailed disclosure about the products received that are not within the Section 28(e) safe harbor. Such revisions should incorporate the disclosure standard set forth in the staff's 1986 release on soft dollars (i.e., disclosure should be specific enough for clients to understand the types of products being purchased and permit them to evaluate possible conflicts of interest) and should require more detailed disclosure about any products or services that are not used in the carrying out of the adviser's investment decision-making responsibilities. In addition, the SEC should require advisers to provide more detailed information to clients upon request. This disclosure could be on a client-specific basis, could include more detailed itemization of the research and products obtained with soft dollars during the previous period, and could include total commission commitments, and total expenses during the period. Finally, Form ADV should be amended to require disclosure of the availability of commission recapture programs to clients if any client of the adviser directly receives cash rebates, products, services, expense payments or expense reimbursements from one or more broker-dealers based on commissions generated by the client's trades placed by the adviser. ` The SEC should publish the Report in order to encourage advisers to strengthen their internal control procedures regarding soft dollar activities. The staff suggests that investment advisers review and consider the controls described in the Report, many of which were observed as effective during examinations. A summary of such control procedures can be found in Appendix F to the Report. \* \* \* Amy B.R. Lancellotta Senior Counsel Attachment Note: Not all recipients of this memo will receive an attachment. If you wish to obtain a copy of the attachment referred to in this memo, please call the Institute's Library Services Division at (202)326- 8304, and ask for this memo's attachment number: 10317.